

FIRST MONETARY POLICY REPORT
FOR 1991

FROM THE

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

A REPORT

together with

ADDITIONAL VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95-523



MAY 23 (legislative day, APRIL 25), 1991.—Ordered to be printed

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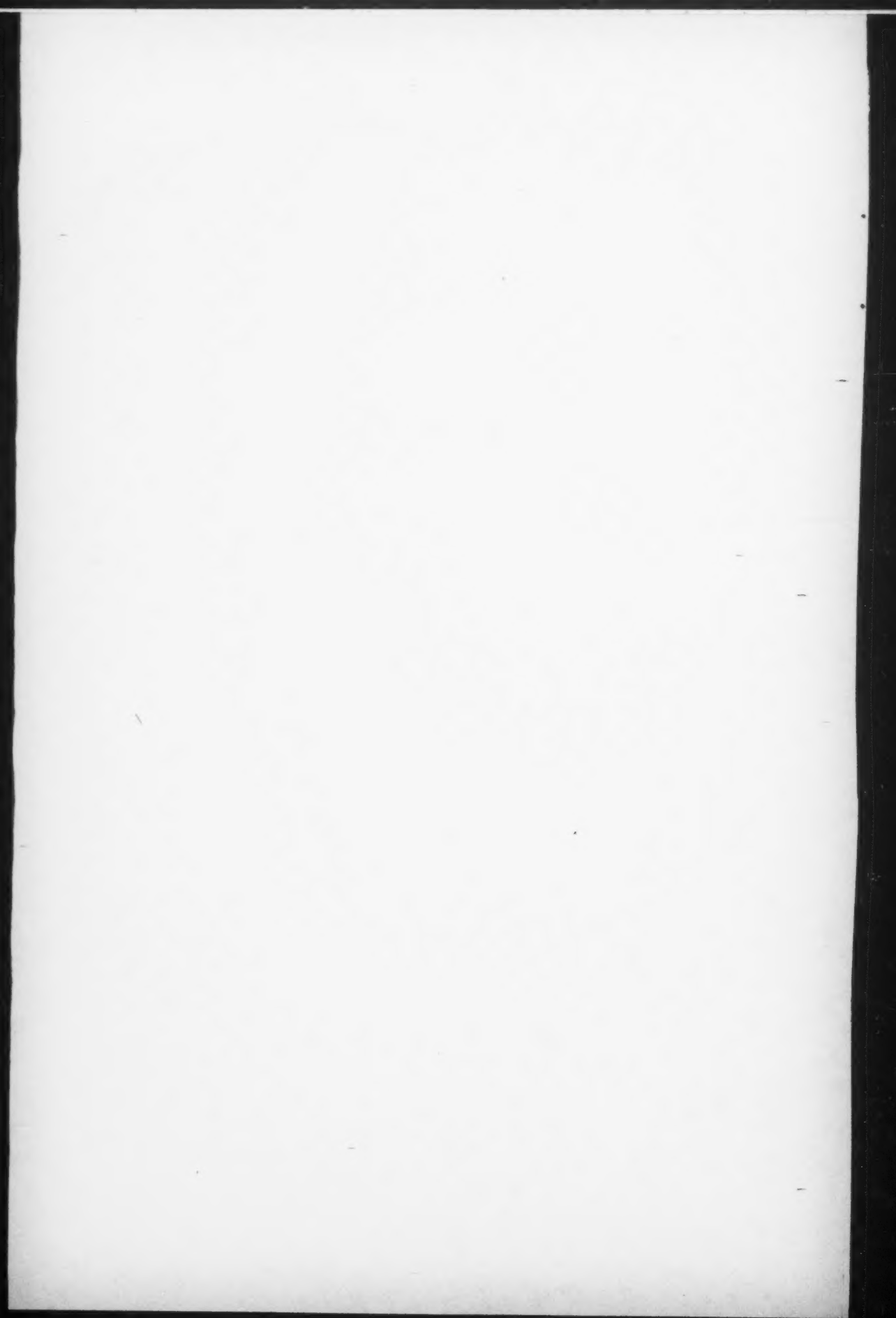
U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC, May 23, 1991.

Hon. DAN QUAYLE,
President of the United States Senate,
Washington, DC.

DEAR MR. PRESIDENT: Transmitted herewith is the first Monetary Policy Report for 1991 on the conduct of Monetary Policy, pursuant to Public Law 95-523 and oversight hearings held on February 20 and 21, 1991.

Sincerely,

DONALD W. RIEGLE, Jr.,
Chairman.



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Mr. RIEGLE, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

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[Submitted pursuant to Public Law 95-523]

INTRODUCTION

On February 20, 1991, the Committee on Banking, Housing, and Urban Affairs held its semiannual oversight hearing on monetary policy, as called for by the Full Employment and Balanced Growth Act of 1978. The Committee received the Federal Reserve's "Monetary Policy Report to the Congress" and heard the testimony of its Chairman on the conduct of policy in 1990 and policy objectives for 1991.

On the following day, the Committee heard the testimony of three highly regarded bank analysts. They were: Carole S. Berger, Senior Vice President of C. J. Lawrence Inc.; William Weiant, Managing Director of The First Boston Corporation; and James Grant, Editor of Grant's Interest Rate Observer. These witnesses discussed the condition of the banking industry and its capacity to channel adequate funding to the economy.

The testimony of the witnesses at both hearings, the Federal Reserve's report, and other publicly available information provided sufficient basis for the Committee's findings and recommendations, which are here offered to the Senate for its consideration and use.

MONETARY POLICY AND ECONOMIC DEVELOPMENTS IN EARLY 1990 AND EARLY 1991

Following the stock market crash in late 1987, the Federal Reserve's concern about the fragility of markets was accompanied by

considerable pressure from the Administration to hold down interest rates, which the Committee commented on in an earlier report. The Fed adopted a cautious approach to interest rates that led to a second year of rapid economic growth, pushing unemployment rates down $5\frac{1}{4}$ percent by the beginning of 1989, a full two percentage points below the average for the preceding ten years. Employment as a percentage of population rose to a record high of 63 percent, and capacity utilization rates rose to 85 percent, the highest since 1979.

Those high rates of resource use increased the risks of accelerating inflation. The Federal Reserve's strategy, which became apparent in 1989 and which Chairman Greenspan affirmed to the Committee in February 1990, was to restrain inflation by providing only enough credit to maintain or reduce resource use rates but not so little as to push the economy into recession. However, slow labor force growth owing to demographic factors, and persistent declines in productivity starting in late 1988, combined to limit severely the pace of economic growth attainable without further increases in resource use rates and left the Fed relatively little margin for error. Starting in the spring of 1989, the economy grew for 6 consecutive quarters at annual rates of less than 2 percent. But while unemployment and employment rates held steady, inflation picked up. The CPI increase in 1989 was the largest in 8 years. And in the first half of 1990, CPI inflation accelerated further to an annual rate of 6 percent.

By the beginning of 1990, the Fed had already lowered its target federal funds interest rate by $1\frac{1}{2}$ percentage points from its peak of nearly 10 percent in early 1989. With the rise in inflation, it was reluctant to ease further. However, two factors may have begun to change the relationship between the interest rates the Fed controlled and the rates paid by consumers and businesses, making the Fed's policy effectively more restrictive.

The first was a rise in long-term interest rates, mirroring similar increases abroad in response to developing investment opportunities in Europe and a tightening of monetary policy in Japan. As those rates rose, foreign investors were less attracted to investments in dollar-denominated securities, forcing up yields in the United States. Mortgage interest rates rose by half a percentage point, reversing earlier declines, and housing starts drifted downward. Corporate bond yields rose as well, raising the effective cost of new investment. In his testimony before the Committee in February 1990, Chairman Greenspan argued that the yield increases might merely be reflecting a stronger economic outlook in the United States, and that to the extent that higher real rates abroad forced up U.S. rates, export opportunities would rise offsetting to some extent the weakness in domestic demand.

The second factor raising effective credit costs was a tightening of credit terms and standards by banks: the credit crunch. By early 1990, increasing bank losses on loans collateralized by real estate and loans made in connection with highly leveraged transactions were seriously eroding the capital positions of a large and growing number of banks. At the same time, recognition of those losses appears to have been accelerated by a series of tougher bank examinations by regulators. Some banks and many of their borrowers re-

ported that a policy of requiring collateral to be marked down to a pessimistic view of its current market value was forcing banks to set aside large loss reserves on loans that were otherwise currently performing and, they believed, likely to continue to do so. Coupled with scheduled increases in bank capital requirements needed to satisfy the Basle accords, these losses pushed many banks to curtail new lending in order to conserve capital, and made banks in general more reluctant to make and extend loans based on real estate collateral.

At a Committee hearing on June 21, 1990, bank regulators agreed that some lenders, especially in New England, had become more cautious, but they saw little sign that there was a broad problem. Three weeks later Chairman Greenspan told the Committee, at another hearing, that while he would not call it a "credit crunch", a tightening of credit standards was becoming a serious problem, and the Federal Reserve was lowering its target interest rates, accordingly. The Fed's move, though, amounted to only $\frac{1}{4}$ of a percentage point.

The following month brought the beginning of the Gulf Crisis and, with it, a sharp runup in oil prices. That had a depressing effect on consumers' real incomes. Although spending on consumption goods and business investment were well maintained in the third quarter, outlays for new housing fell sharply. Consumers paid for higher fuel costs by reducing their rate of savings, but higher borrowing rates, uncertainty about the economy, and the weakness in house prices reduced the attractiveness of major housing investments. Difficulties of builders in obtaining credit may also have contributed. Housing investment continued its decline in the fourth quarter, and consumers were evidently unwilling to reduce their savings rate any further, as the economy slid into recession.

Following the small July easing, the Federal Reserve held firm until late October, despite a greatly increased likelihood of recession following the invasion of Kuwait. The Fed's report justifies that decision on the basis of concern that Fed action would raise inflation expectations and might have to be reversed suddenly. As the prospects for a quick end to the crisis ebbed, the Fed apparently became concerned that, if it acted before a budget agreement, it would seem to be caving in to Administration pressure.

Finally after the budget agreement, the Fed eased modestly, but it remained more concerned with inflation and the dollar than with the increasingly apparent deterioration in the economy. Further reductions followed in a deliberate fashion over the next 5 months, decreasing the federal funds rate by a total of 2 percentage points below its mid-October level to 6 percent. Many other key interest rates have responded only in part. The prime rate has declined only 1 percentage point since the beginning of 1990. Long-term borrowing rates are down half a percentage point from last fall, but have merely returned to approximately their year-end 1989 levels.

Money growth was weak over much of the past year. The Fed's principal monetary aggregate, M2, grew at 3.9 percent from the fourth quarter of 1989 to the fourth quarter of 1990, within the Fed's target range of 3 to 7 percent. But the pattern during the year paralleled the deterioration in the economy and the accelera-

tion of the RTC's closing and sale of insolvent thrifts, which spurred some depositors to place their funds in non-depository investments. After a fast start, growth of M2 slumped in the second and third quarters last year, then slowed further until mid-January. Since then, money stock growth has picked up considerably, but for the year ending in March, it had increased only 3.3 percent.

MONEY GROWTH TARGETS AND ECONOMIC PROJECTIONS FOR 1991

This year, the Fed lowered its target ranges for both M2 and debt by $\frac{1}{2}$ percentage point, despite the recession.

TABLE 1. FEDERAL RESERVE TARGET RANGES FOR MONETARY AND CREDIT AGGREGATES

	1991	1990	1990 (actual)
	Percentage change, 4th quarter to 4th quarter		
M2.....	2½ to 6½.....	3 to 7.....	3.9
M3.....	1 to 5.....	1 to 5.....	1.8
Debt.....	4½ to 8½.....	5 to 9.....	6.9

The Fed believed its targets to be consistent with a quick recovery. Its projections showed net economic growth for the year, with sharply reduced inflation and a consistently raised level of unemployment.

TABLE 2. FEDERAL RESERVE ECONOMIC PROJECTIONS

(FOMC members and other FRB Presidents, central tendency)

	1991	1990 (actual)	1989 (actual)
	Percentage change, 4th quarter to 4th quarter		
Nominal GNP.....	3¼ to 5¼.....	4.5	5.6
Real GNP.....	3¼ to 1½.....	2.5	1.8
CPI.....	3¼ to 4.....	6.1	4.6
	Average level in the 4th quarter		
Civilian Unemployment Rate.....	6½ to 7.....	5.9	5.3

The expected reduction in inflation was based in large part on the reversal in energy prices which occurred early this year.

SUMMARY OF TESTIMONY OF CHAIRMAN GREENSPAN

In discussing the economy's prospects for 1991, Chairman Greenspan indicated that the status of the Gulf War (in mid-February) added considerable uncertainty to the economic outlook. He argued that the events in the Persian Gulf region and the credit crunch were the key causes of the recession. He judged that, regardless of developments in the Gulf, real estate problems would be a drag on the economy for some time. "Nevertheless," he said, "the balance of forces does appear to suggest that this downturn could well prove shorter and shallower than most post-war recessions," because of the reversal in oil prices, the declines in interest rates (which began, atypically, well before the recession), the benefits of decreases in the dollar's exchange value for exports, and lean inventories. However, the Fed's report that because of concerns about

the war, real estate markets, and the huge debt building during the 1980s, "the Board members and Bank Presidents perceive that, in the near term, the risks to the economy may be skewed to the downside."

In his view, a moderation of inflation concerns, largely owing to the reduction in oil prices in mid-January was critical to further easing steps by the Federal Reserve:

Absent such a lessening of price pressures, monetary policy easing probably would have risked a heightening of inflation expectations, which could have put the foreign exchange value of the dollar under severe downward pressure and fed through to long-term interest rates, perhaps even pushing them higher.

He indicated that the behavior of M2 had also become a more important factor in the Fed's decision making than it had been in years. While the target range was lowered for 1991, consistent with the preliminary range announced last July, the Fed's report noted that "Committee members stressed that M2 expansion noticeably above the lower end of the range likely would be needed to foster a satisfactory performance of the economy in 1991."

The Fed's Chairman also addressed concerns that the Federal Reserve might not have adequate tools to ensure a recovery. He said he thought the risk was exaggerated because the Fed's ability to lower short-term interest rates could stimulate spending by lowering short-term borrowing costs. Those lower rates could and had lowered the costs of equity finance and, through their effect on exchange rates, increased the competitiveness of U.S. exports. But he said other measures would be needed to combat the credit crunch and that bank regulators were working on a supervisory statement (which was subsequently issued on March 1) to reduce any undue lending inhibitions of banks.

In response to a question from Senators Graham and Roth about the origins of the real estate problems, Chairman Greenspan said that lax lending standards and lax supervisory standards were important factors. He added that excessive incentives in the 1981 tax act to produce commercial buildings followed by the removal of those incentives in 1986 contributed by increasing supply and then removing the justification for the increases.

Senator Kerry asked whether recent increases in German interest rates were making it difficult or dangerous for the Fed to move U.S. interest rates. The Fed Chairman responded:

There's been a lot of discussion that somehow, we're going in different directions. But I can assure you that the president of the Bundesbank and myself have had innumerable conversations in recent months over this issue and have kept each other very well informed as to what our policies were and have been coordinating to try to mesh this issue in a manner in which we would not be creating galvanic disruptions in the exchange market, which would have very negative effects back in the United States, largely through rises in long-term interest rates

here, which would probably have a very negative effect on American economic activity.

In response to a question from Senator Heinz, Chairman Greenspan explained that, based on past statistical relationships, the decreases caused by the Fed in the federal funds rate should have been adequate to keep M2 well within the center of its target rate. He attributed the shortfall to the credit crunch—a term he was now willing to use.

Chairman Riegle asked why banks had not lowered the prime rate in line with decreases in the funds rate, and Mr. Greenspan replied that it was a symptom of the credit crunch, reflecting banks' disinterest in making loans because of capital and regulatory concerns. And in further discussion about the state of the economy he said, "more than any other time that I can recall, this economy is driven by confidence rather than physical forces."

SUMMARY OF TESTIMONY—BANK ANALYSTS

Carole Berger, of C.J. Lawrence Inc., told the Committee that nonperforming loans for the 45 banks she researches increased last year from 3 percent of assets to 4.8 percent—double the level reached in the 1982 recession—making the current problems the worst in 50 years. Commercial real estate is the main area of weakness. At nearly 25 percent of loan portfolios, she said, it is a much larger segment than even the LDC loans in the early 1980s, which were only 12 percent of loans at the largest banks and a very small share at other banks.

It was her understanding that effective rents in Boston and New York had declined 50 percent in 18 months. That would imply a similar decline in property values. If those decisions spread to other markets and loans were made at 75 percent loan-to-value ratios, loan losses could be 33 percent of commercial real estate portfolios. Compounded by recession-related losses on other loans, the total would be devastating.

William Weiant, of The First Boston Corporation, noted that not all banks have problems. They collectively reported earnings of \$28 billion in 1990, and he projected a similar level for 1991 and increases in 1992 and 1993. For the 45 large banks that he follows, average return on assets is expected to be 0.70 percent in 1991, with a return on equity of 12 percent. Tangible common equity is more than 5 percent, well in excess of regulatory minimums.

He saw real estate as a continuing and worsening problem, though. He expected nonperforming real estate loans to increase an average of 50 to 75 percent in 1991, with problems spreading to the Midwest and California. He expressed the belief that banks' real estate ills stemmed from the general decline in inflation in the 1980s, the Tax Reform Act of 1986, the demise of the thrift industry, and changes in lending terms by banks and other lenders.

Another problem area is loans for highly leveraged transactions (HLTs). He predicted that the share of such loans which are nonperforming will triple to 15 percent and that, ultimately 20 to 30 percent of the nonperforming loans will be charged off. That would amount to 3 to 4½ percent of existing HLT portfolios.

He anticipated that some banks, including some of the largest, will develop a shortage of equity capital. Many banks will continue to have reduced access to capital market funding. And all banks will have to pay greatly increased FDIC deposit insurance premiums.

He did not blame the regulators, however. In his view, recent tough examinations "were simply recognizing erosion in real estate values that had been occurring for at least two years and simply had not been properly identified by bank managements. The regulators were doing a service to the industry, not a disservice." While he agreed that credit availability for some lenders had been curtailed, he said it was "something that should be welcomed given the burden of debt that is evident in all sectors of the economy." To minimize the effects on the economy, Mr. Weiant said he thought decreasing interest rates by the Fed, as they had done, and recapitalization of the Bank Insurance Fund were the right measures.

James Grant, of Grant's Interest Rate Observer, testified that a dramatic relaxation of credit standards and the entry of banks into commercial real estate lending were at fault. He blamed the deposit insurance system, which he said had led to the socialization of risk. He argued that high interest rates had raised funding costs and had tempted banks to "reach for yield" by taking on more risk. A very low inflation and low interest rate environment would help give banks the incentive to make safer loans.

FINDINGS AND RECOMMENDATIONS

1. The Credit Crunch

The weakened condition of segments of the banking industry has constricted lending and dims the outlook for rapid economic recovery. As Chairman Greespan indicated in his response to a written question, the effects of the credit crunch are difficult to measure in any quantitative way. The increase in overall bank loan portfolios was down more than 50 percent from the previous year, and net lending to nonfinancial business (excluding residential mortgages) declined by almost two-thirds. But these data are not solely indicative of a credit crunch. They reflect changes in demand as well as supply.

The weakness in the economy reduced business spending plans, generally. And the absolute decline in bank loans for commercial real estate construction and development surely reflects primarily the weakness in real estate markets. Business demand for new funds also decreased sharply because of a much slower rate of debt-financed mergers and acquisitions. While an inability to acquire funds was part of the cause, the poor performance of many recent deals undoubtedly reduced interest in such transactions. And, although bank lending was reduced, other lenders took up the slack to a considerable extent. For example, last year, growth in business loans from non-bank finance companies, which amount to nearly half as much as bank commercial and industrial loans, accelerated to an increase of more than 12 percent.

The true measure of the credit crunch is the extent to which the cost of borrowing has increased, relative to market interest rates.

For borrowers that can access credit markets directly, the cost has not increased. For those that can borrow at prime rates, the cost appears to have risen by about a percentage point. Federal Reserve surveys of bank lending practices show that a very large proportion of banks have tightened their terms and standards for loans over the past year. While most banks that have tightened referred to the weak economy as a reason, many responded that problems meeting bank capital requirements and deterioration in their loan portfolios were major factors in their decisions, and preliminary data indicate that well-capitalized banks were expanding their loan volumes while poorly capitalized banks were retrenching.

Clearly, some borrowers have been effectively shut off. Because of the recession and the real estate problems, many of these firms have become worse risks. But worthy borrowers are affected as well, and they are affected unevenly. Borrowers that normally depend on other sources of funds observe little change in borrowing terms. Some of those that rely on banks will suffer harsher terms there or endure costs in shifting to alternative lenders. But for some worthy borrowers, these costs will be prohibitive, and they will cut back on their spending.

Under such circumstances, the Fed should lower, and says that it has lowered, the general level of interest rates more than it otherwise would, helping all borrowers. But the overall mix of loans will shift away from small firms where growth has traditionally been highest. This will inhibit the economy's performance, even at lower interest rates. With prospects for capital problems and insolvencies at some banks extending well into the future, the Fed will have to continue to monitor bank credit closely and adjust interest rates accordingly for some time.

The Fed and the other bank regulators have also attempted to attack the credit crunch with a set of new guidelines affecting bank accounting. Committee members have received numerous complaints that a pattern of "overly zealous" bank examinations is largely responsible for the credit crunch. The regulators deny that such a pattern has existed and affirm their intent not to discourage good loans to good borrowers and to see that reporting of earnings and losses be fair and accurate.

To the extent that the new guidelines merely clarify that, they are appropriate. However, the Committee believes that the ability of such steps to solve the problem is limited, at best. Memories of past losses and worries about the economy will continue to make banks wary. Some banks that have made too many bad loans in the past will still be short of capital; decisions by them to restrain their growth are inevitable and, in the absence of sufficient capital infusions, often appropriate. Regulators must not be tempted to try to solve the problem by turning to special regulatory accounting standards or a general policy of capital forbearance that could create worse problems later. Indeed, the mounting losses that we are experiencing now in the banking system largely reflect inadequate supervision of real estate lending in the past. Ultimately, the best solution to the credit crunch is a healthier economy and a healthier banking system.

2. Market constraints on Federal Reserve policy

Chairman Greenspan has referred several times to concerns about the reaction to possible policy changes in the foreign exchange and domestic bond markets. If the Fed eases and investors, particularly foreign investors, judge that the action will prove inflationary in the long-run, bond prices may fall, raising borrowing costs just when the Fed would like to ease them. Such a result, in fact, has occurred on at least one occasion in recent months. This sensitivity of debt markets to investor attitudes appears to have increased in recent years, owing to the greater ease and speed with which investors can now switch among international markets.

There is some virtue in this veto power of the markets, in that it makes an irresponsible course even less attractive. And it puts greater pressure on the Fed to establish a credible record over time. But it also complicates the Fed's task by making the effect of a policy change less predictable, and it may lead to a tendency by the Fed to follow the market, to wait until the market is properly prepared for a change. If it means only occasional short delays, little damage is done. But regular and long delays when a policy change is appropriate should be resisted. Even if bond yields do not decline immediately following a reduction in short-term rates, the decrease in short-term rates has some effect by itself, and an orderly decline in the dollar can achieve some of the same effects by spurring U.S. exports and slowing imports. Different industries are stimulated by a decline in the dollar as opposed to a decline in interest rates, but the net impact on U.S. growth is similar.

3. Federal Reserve policy in recent years

The Committee believes that Federal Reserve policy during the nearly 8 years of economic expansion ending last year was a key factor in maintaining the expansion. During those years, the Fed managed to keep core consumer price inflation within a narrow 3.8 to 4.8 percent range. That is an impressive achievement, and the Fed deserves a lot of credit for it.

More recently, however, the economy's performance has been much poorer, with the development of a painful and damaging recession. In retrospect, it is clear that more aggressive or earlier easing by the Fed would have produced better results. The Fed argues that the recession was caused by the credit crunch and the Gulf crisis, which were difficult to recognize and impossible to predict, respectively. But before those factors became significant, economic growth was essentially nil in the second quarter last year and positive in the third only because of a decline in the household saving rate. Housing starts fell steadily throughout the year, and the dollar's rise during much of 1989 halted progress in improving net exports. At the same time, however, inflation was accelerating mildly, and the dollar reversed its earlier gains, so to some degree the Fed's caution was understandable.

After the invasion of Kuwait, the Fed was faced with both incipient recession and oil-price-related inflation, and balanced those concerns by doing nothing. Again, in retrospect, earlier easing would have produced better results, but a quick diplomatic solution

in the Gulf of a war that sharply contracted oil supplies might have justified a different conclusion.

4. The Federal Reserve's policy plans in 1991

More recently, the Fed has moved to lower rates considerably. There has been ample reason to do so. The unemployment rate has risen 1½ percentage points, housing starts and auto sales approximate their 1982 lows, and inflation appears increasingly under control.

The Federal Reserve's broad policy plans for 1991 are, as usual, quite vague, but, as far as they go, they appear to be reasonable. For the year, the Fed's M2 growth target is 2½ to 6½ percent. While that represents a decrease from last year, the range is so wide that it still allows for the possibility of a substantial increase this year. And the Fed report's statement that FOMC Members expect that M2 growth will need to be well above the minimum is reassuring. So are the Fed's economic projections, which imply an early and healthy recovery, though that prospect remains in considerable doubt.

The Committee agrees with the judgment of Federal Reserve policy-makers that the risks in the economy are to the downside. Recent economic data clearly show that credit conditions remain constrained and the recession is still in progress. The fragile condition of some of our financial institutions and the huge debt levels throughout the economy increase the chances that a continuing recession could become very serious. The economic and, more importantly, the human costs of a deep recession are lasting. The products not made, the capital not put in place, and the wages foregone are gone forever. Countless people are greatly harmed by serious economic downturns and intelligent policy must always attempt to avoid them—and bring them to a prompt end when they occur.

Accordingly, the Committee believes the Fed should err on the side of credit easing, until the beginning of a recovery becomes well established. A policy targeted to a deeper recession than has been expected can be balanced by a tighter policy later on, if the recovery comes soon. But if the recession turns out to be deeper and longer, a policy targeted to a mild recession will have been an irretrievable mistake.

ADDITIONAL VIEWS OF SENATORS JIM SASSER, PAUL S. SARBANES, TERRY SANFORD, AND RICHARD H. BRYAN

SERIOUS RECESSION

The U.S. economy has been experiencing a serious recession since July 1990. More than 8 million Americans are out of work. Indeed, it appears that the traditional measures of economic performance—the unemployment rate and GNP—do not fully reflect the severity of the current economic downturn. There are signs that the recession is even worse than these widely-watched statistics indicate. Over the last nine months, businesses have reported a decline of 1.4 percent in nonfarm payroll employment, a worse decline than the 1.2 percent drop averaged in other recessions at least nine months long (1953-54, 1960-70, 1973-75, 1981-82).

Even though the rate of job loss during this recession is greater than the average rate during previous recessions, the unemployment rate has not risen as much. This is as a result of a dramatic slowdown in labor force growth such that the ranks of the unemployed are no longer being swelled by new entrants coming into the labor force to look for work. The fraction of the labor force who have lost their jobs and are still looking for work has risen from 2.8 percent in August 1990 to 3.8 percent today, a larger increase than that experienced in the average of the last four recessions.

According to official and widely-relied upon estimates earlier this year, GNP contracted at an annual rate of 1.6 percent in the last quarter of 1990 and 2.8 percent in the first quarter of 1991. However, based upon recently released and more pertinent 1987 price data, the GNP drop in the 4th quarter was actually 3.5 percent.

Indeed, the credit sensitive automobile and construction industries have been particularly hard hit. Car sales are running 18 percent below the disappointing levels of the same period a year ago. Indeed, the "Big Three" auto companies are projecting a 1991 loss of \$2.7 billion. In the construction industry, more than twice as many jobs have been lost in the first eight months of this recession than in the first eight months of the 1981-1982 recession. Contracts for new construction fell in March to the lowest level since 1983.

Moreover, the nation's banking system is facing its greatest crisis since the Great Depression; banks are experiencing record losses. According to the General Accounting Office, the Federal Deposit Insurance Corporation could well become insolvent before the end of the year without corrective action. To further complicate matters, a credit crunch brought on by a shift from excessively lax examination standards has swept over the country, making it extremely difficult, in many cases, for credit worthy individuals and businesses to borrow needed funds.

DECADE OF DEBT AND NEGLECT

The recession is most clearly a result of the excesses of the 1980s. Beginning with the large 1981 Reagan tax cut, and the significant increase in defense spending, the federal government followed an extremely expansive fiscal policy. Indeed, the national debt has increased from \$1 trillion in 1980 to more than \$3 trillion today. At the same time, the effective tax rates on the richest Americans have been reduced and effective tax rates on middle-income and working Americans have increased.

In addition, during the 1980s, corporations increased their borrowings dramatically replacing \$600 billion of equity with debt. This massive increase in leveraging was brought on by the hostile takeover craze, the junk bond phenomena, and other activities in the securities markets that were largely overlooked by federal authorities but had a significant impact on American business and its competitiveness. The need to service extraordinary debt levels has made American business much less able to weather a severe recession.

Moreover, the deteriorating condition of financial institutions beginning with the large scale collapse of savings and loans in the mid-1980s, and emerging problems in commercial banking later in the decade, had as a root cause a lack of prudent regulation during the 1980s. Traditional concerns for safety and soundness gave way increasingly to a philosophy of letting "the market" be the regulator of federally-insured financial institutions. Consequently, financial institutions entered the recession in a very weakened state and have not been a positive force in bringing us out.

MONETARY POLICY

Against this backdrop of budget deficits, overleveraging in the private sector and a weakened financial services system, the Federal Reserve has had a difficult job. However, we believe that in the recent past the Federal Reserve has overestimated the potential of renewed inflation, and ignored fragility in the corporate and banking sector, thereby adopting too restrictive a monetary policy. Over the past few years, the Federal Reserve has been too slow to react to changes in the economy that signalled recession.

Even as the recession has concluded its ninth month the Federal Reserve's response has been inadequate. The percentage decline in the Federal Funds and Discount rates has been significantly less in this recession than in previous ones. Since this recession began, the Federal Funds rate has declined only 2.5 points, from 8.29 in July 1990 to 5.75 currently. This compares to much sharper declines for earlier recessions: 5.5 points in 1969-71, 7.7 in 1974-75, and 10.6 in 1981-83. Indeed, the Federal Funds rate started higher and ended lower for each of the first two recessions. Even reaching back to the recent 9.85 peak for the Federal Funds rate in March 1989, the rate has come down only 4.1 points.

FEDERAL FUNDS RATE

Period	Peak	Trough	Absolute change	Percent change
August 1969 to March 1971.....	9.19	3.71	5.48	-59.6
July 1974 to May 1975.....	12.92	5.22	7.70	-59.6
June 1981 to February 1983.....	19.10	8.51	10.59	-55.4
July 1990 to Present.....	8.29	5.75	2.54	-30.6
March 1989 to Present.....	9.85	5.75	4.10	-41.6

Over the 15 months ending in the Spring of 1989, the Federal Reserve increased interest rates by more than three percentage points. During the second half of 1989, the Federal Reserve eased by 1.5 percent. However, from the beginning of 1990 until late Fall, in the face of steeply declining economic activity, the Federal Reserve kept interest rates essentially constant. In July 1990, to offset reduced bank lending, the Federal Reserve dropped the Federal Funds rate from 8.25 to 8 percent. In doing so, however, it was made clear that the credit crunch was the rationale for easing, rather than economic weakness. This sent the wrong signal to the financial markets at a critical time.

Indeed, on July 18, 1990, after we now know the recession had begun, Chairman Greenspan testified before the Committee that the "economy still appears to be growing and the likelihood of a near-term recession seems low."

Later in the fall of 1990, as the economy continued to decline, and the Congress labored over an agreement to cut the budget deficit by \$33 billion in Fiscal Year 1991 and \$482 billion over 1991-1996, the Federal Reserve refused to act to lower interest rates, preferring to wait until after the budget agreement was finally enacted. In response to a question about the Federal Reserve's ability to ease rates to stimulate the economy, Chairman Greenspan told the Committee "that monetary policy changes can be suggested, debated, decided, and implemented in a very short span of time," implying that the Federal Reserve had the time to avoid a recession.

Yet, the Federal Open Market Committee (FOMC) was undecided about the course of the economy as late as last Fall. Certainly, changes affecting monetary policy were not implemented quickly. The Federal Reserve did not begin to seriously reduce interest rates until December, when the economy was already in its sixth month of recession. We believe that the Federal Reserve's lack of action in the Fall further exacerbated the recession.

In addition, a disagreement between the governors of the Federal Reserve and the district bank presidents over the authority of the Chairman to act to lower interest rates in between meetings of the FOMC has not been productive, and raises concerns about the ability of the FOMC, as it is presently composed, to respond to market developments. The narrow focus of many of the district bank presidents with inflation has made it more difficult for the Federal Reserve to address negative economic developments such as increases in unemployment and the recession generally. It also raises the question of whether the district bank presidents who are not selected through a public process are appropriate agents under the Constitution to fulfill the public policy purposes of the FOMC.

RECOMMENDATION

We believe that the Federal Reserve can and should do much more to stimulate the economy to recovery. Interest rates are high relative to activity in the economy. Indeed, banks are not passing on to consumers the benefit of the Federal Reserve's recent reductions in the Federal Funds and Discount rates as they have in previous recessions. Instead, banks are attempting to raise profits to respond to the pressure to strengthen their financial condition and to compensate for past serious lending mistakes in commercial real estate.

Another reason for the Federal Reserve to ease more aggressively is that unemployment compensation is not providing the stabilizing effect that it has in the past. Presently, less than half of the unemployed are receiving unemployment benefits. During past recessions that share has been typically above 50 percent and has approached 75 percent.

Most of all, inflation shows no evidence of becoming a serious threat to the economy. Indeed, we believe that the Federal Reserve's focus on inflation has contributed to the severity of the recession. We agree with James Tobin who told the Joint Economic Committee on May 9, 1991, "wage and price inflation are well-behaved, I see no reason to prolong this recession by a new anti-inflation crusade."

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